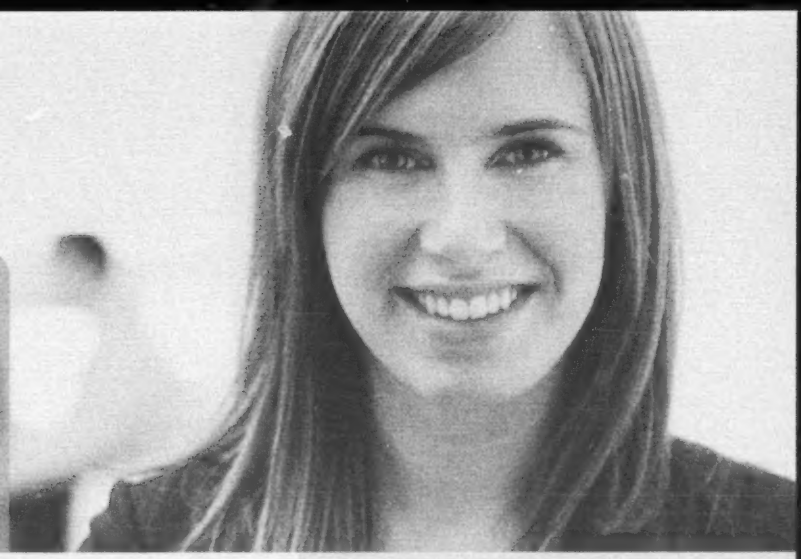
BDC
Entrepreneurs first

economic LETTER

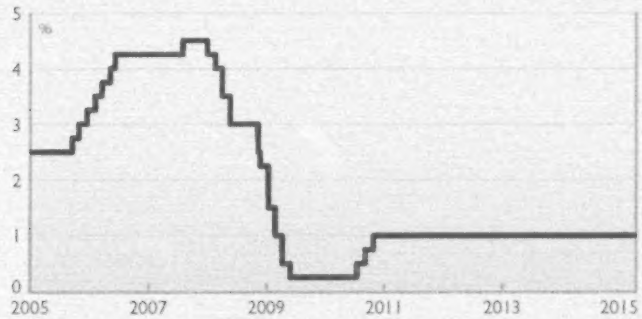
JANUARY 2015



COULD INTEREST RATES HEAD UP IN 2015?

For six years now, that is, since the financial crisis that shook the world in 2008, Canadian interest rates have stayed low. The key interest rate set by the Bank of Canada, which influences all the market interest rates—such as those offered on savings products or those that apply to business or personal loans—has been frozen at 1.0% since September 2010 (graph). Can we expect it to go up in 2015, triggering a hike in market interest rates?

Target for the overnight rate
(January 2005 to January 2015)



Source: Bank of Canada

To answer this question, we need to examine the outlooks for Canadian economic growth. For the year just ended, forecasters estimate that real GDP grew by 2.4% compared with the previous year.[1] For 2015, they are expecting a fairly similar rate of growth: 2.5%. The Bank of Canada predicted the same in October.[2] Will such growth be enough to encourage the central bank to raise the key interest rate?

Over the course of 2014, Canadian exports picked up steam thanks to a weaker Canadian dollar and the firming up of economic activity in the United States. Many indicators tell us that the U.S. economy is doing better and better, and ▼

1 Average of the forecasts of 17 financial institutions (Consensus Forecasts of December 8, 2014). The results of the last quarter of 2014 will not become known until the end of February 2015, therefore it is necessary to estimate growth for 2014.
2 Bank of Canada, Monetary Policy Report, October 2014.

Canada
- Firm GDP growth
- A slight drop in employment
- The trade balance deteriorates
- Housing starts lose ground

United States
- Continuing vigour in job growth
- Housing starts falter
- Consumer confidence remains high

Interest rates
The key interest rate could head up towards the end of 2015

Oil price

Canadian dollar

SME confidence

Key indicators

BDC's Monthly Economic Letter is prepared by the Economic Analysis team from Marketing and Public Affairs and is based on a variety of public sources of economic data. The information in this letter is drawn from data released prior to January 10. Reliance on and use of this information is the reader's responsibility.

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forecasters expect this trend to continue, since they are forecasting that U.S. real GDP will grow by 3.0% in 2015.[3] Canadian exports should therefore keep expanding this year, which would encourage businesses to invest more. In fact, for the first time in two years, we noted a significant increase in machinery and equipment investments in the third quarter of 2014, which is a promising sign. Over time, this should translate into acceleration in job creation.

If this scenario comes to pass, the excess production capacity will gradually melt away, and the central bank will be able to raise the key interest rate. The fact is that the Bank of Canada would probably like to raise the key interest rate as soon as possible, since the extraordinarily low level of market interest rates has undesirable effects. For one, it encourages consumers to take on debt, as may be seen from the household debt ratio, which has reached a historic peak. For another, it encourages investors, who are looking for better returns, to take on more risk than they would ordinarily do.

A few months ago, the majority of forecasters believed that the scenario described above would materialize and enable the central bank to raise the key interest rate during the second half of 2015; but the recent plunge in oil prices has muddied the waters. Although it is difficult to quantify the effect that this price slump will have on the Canadian economy, most analysts estimate that it will be negative and that it will encourage the central bank to postpone raising the key interest rate.[4] We will find out more about this on January 21, when the Bank of Canada releases its Monetary Policy Report. Nevertheless, at the beginning of January the economists of four of the seven Canadian chartered banks were anticipating an initial key interest rate hike in 2015 (see table).

Expected value of the Bank of Canada's key interest rate at the end of the quarter

	2nd quarter 2015	3rd quarter 2015	4th quarter 2015
RBC Royal Bank	1.00%	1.25%	1.50%
CIBC	1.00%	1.00%	1.25%
BMO Bank of Montreal	1.00%	1.00%	1.25%
Scotiabank	1.00%	1.00%	1.00%
TD Bank	1.00%	1.00%	1.50%
National Bank	1.00%	1.00%	1.00%
Laurentian Bank	1.00%	1.00%	1.00%

In any event, if the key interest rates were in fact to head up this year, the increase would certainly be limited. The economy will have to grow sustainably in order for interest rates to return to where they stood prior to the financial crisis, and that could take a few more years. ■

CANADA

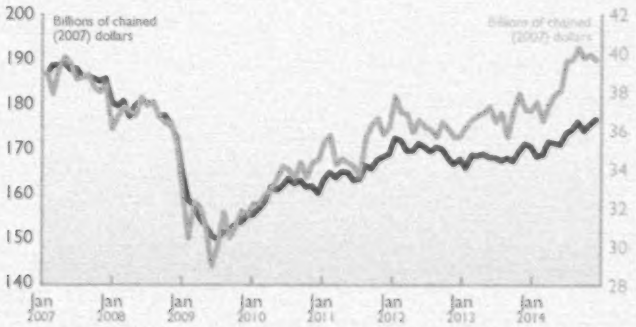
Back

It is difficult to estimate what effect the plunge in oil prices will have on the Canadian economy, but the value of exports was impacted in November. That said, the last quarter of 2014 got off to a good start, with solid real GDP growth in October. Lastly, the labour market improved markedly in 2014, compared with the previous year.

Firm GDP growth

After an advance of 0.4% in September, real GDP grew by 0.3% in October. The main contributors to this growth were the public sector—especially education services, where production returned to normal after a labour dispute in September—mining, oil and gas extraction, and manufacturing. In the latter sector, production picked up steam in 2014 thanks to a surge in exports, stimulated by the recovery in the U.S. economy and the depreciation of the Canadian dollar (graph). ▼

Manufacturing output and export volumes
(January 2007 to October 2014)



Source: Statistics Canada

3 Consensus Forecasts of December 8, 2014.

4 Declining oil prices will no doubt trigger a pullback in activity in the oil sector and related industries, but the resulting depreciation of the exchange rate will stimulate activity among exporting companies. Furthermore, the savings enjoyed by Canadian consumers thanks to lower gasoline prices will stimulate their consumption of other goods. Lastly, since the U.S. is a net importer of oil, the effect on that country's economy should be positive, which will be beneficial to Canadian exporters. Given that the plunge in oil prices has multiple effects, and not all in the same direction, it is very difficult to estimate its net effect.

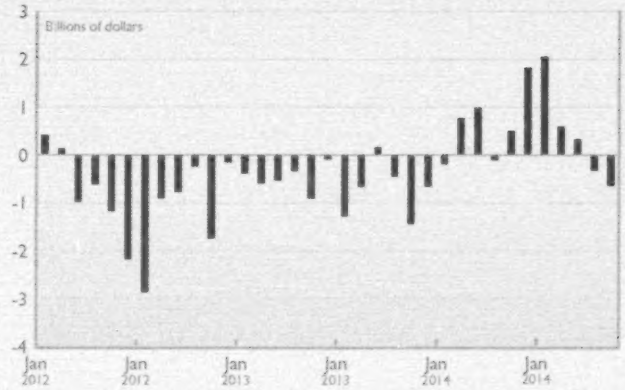
A slight drop in employment

Full-time jobs increased by 53,500 in December, but 57,700 part-time jobs were lost, so net employment recorded a slight drop of 4,300. For the year 2014 overall, i.e. between December 2013 and December 2014, we note a gain of 185,700 jobs. This increase consists entirely of gains in full-time employment (190,300), since part-time jobs declined (4,500). These results are a definite improvement from the year before: in 2013, employment expanded by just 99,000 jobs, and the majority of gains were in part-time work (93,700). Meanwhile, the unemployment rate fell from 7.2% in December 2013 to 6.6% in December 2014.

The trade balance deteriorates

Exports dropped by 3.5% in November, while imports pulled back by 2.7%. Consequently, the trade deficit widened, from $327 million in October to $644 million in November (graph). The decline in exports is generalized, since nine out of eleven sectors recorded downturns; but it was energy products, metal products and non-metallic mineral products that bore the greatest responsibility for that decline. The slump in imports is also generalized; only automotive vehicles and parts recorded an increase in November. A large portion of the pullback in exports is due to lower prices, especially those of oil and metals, but volumes also contracted during the month, at a rate of 1.6%.

Trade balance
(January 2012 to November 2014)



Source: Statistics Canada

Housing starts lose ground

Housing starts fell in December, to 180,560 units from 193,199 units in November. This drop is mainly attributable to starts of multiple-dwelling projects in urban centres, which tumbled by 7.0%; the decline in the single-family homes segment was less pronounced (-4.8%). In 2014 as a whole, the number of housing starts rose slightly from the year before, from 187,923 units to 189,401 units. The Canada Mortgage and Housing Corporation predicts that the number of housing starts will increase only slightly in 2015. ■

★ UNITED STATES

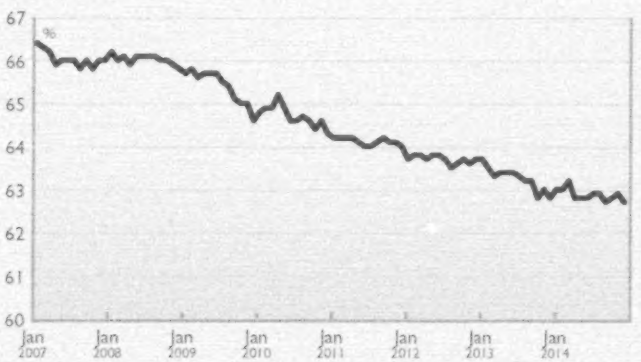
Back

The definite improvement in the labour market in 2014 confirms that the U.S. economy is gaining strength. Moreover, the consumer confidence index, which has reached a seven-year peak, bodes well for consumption and leads us to believe that economic growth will accelerate in 2015, as expected.

Continuing vigour in job growth

Employment recorded an increase of 252,000 jobs in December, and the gains of November and October were revised upwards, by 32,000 and 18,000 respectively. The unemployment rate dipped by 0.2% in December, reaching 5.6%. Between December 2013 and December 2014, the average monthly change in employment rose to 246,000, versus 194,250 in the previous year. The unemployment rate dropped from 6.7% in December 2013 to 5.6% in December 2014. Clearly, there was definite improvement in the labour market in 2014. That said, there is still room for further improvement, as may be seen from the participation rate (sum of employed and unemployed as a percentage of the population), which has remained low since the recession (graph). ▼

Participation Rate
(January 2007 to December 2014)

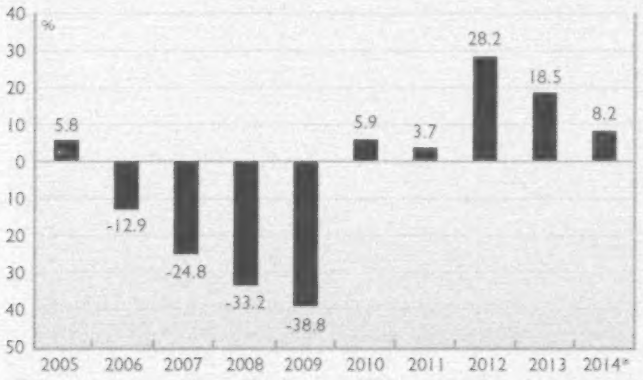


Source: U.S. Bureau of Labour Statistics

Housing starts falter

Housing starts fell by 1.6% in November compared with the previous month. They spurted up by 7.6% in the multiple-dwelling segment, but sank by 5.4% in the single-family home segment which constitutes two thirds of total housing starts. The upturn in housing starts continued in 2014. During the first eleven months of the year, they were up by 8.2% compared with the same months of the previous year. However, this is slower growth compared with that of 18.5% in 2013 and 28.2% in 2012 (graph). Many factors are keeping demand for new homes in check, in particular rising prices and mortgage rates, but the slow pace of household formation appears to be a key reason. Job growth and rising incomes should encourage more young Americans to become homeowners in the coming year.

Housing starts (Annual change from 2005 to 2014*)



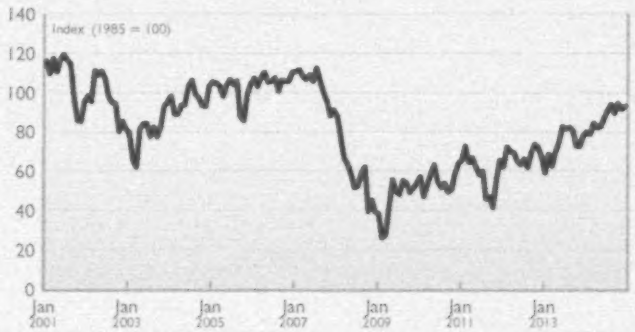
*Growth during the first eleven months of the year

Source: U.S. Census Bureau

Consumer confidence remains high

The consumer confidence index compiled by the Conference Board edged up slightly, from 91.0 in November to 92.6 in December. Consumer confidence improved significantly in 2014; in fact, in recent months the index has reached a seven-year high. Stronger consumer confidence should lead to accelerated consumption in the months ahead. Given that consumer spending represents approximately two thirds of GDP, this bodes well for economic growth.■

Consumer confidence index
(January 2001 to December 2014)



Source: U.S. Conference Board

INTEREST RATES

Back

The key interest rate could head up towards the end of 2015

On January 21, the Bank of Canada will announce its setting of the key interest rate. That rate has held steady at 1.0% since September 2010 and should continue to do so for several months to come, but a hike towards the end of the year is possible (see our lead story on page 1). On the same date, the central bank will issue its Monetary Policy Report in which it will present its analysis of the Canadian and international economies, along with its outlooks for 2015 and 2016. It will be interesting, among other things, to see what assessment the central bank makes of the effect of plunging oil prices on the Canadian economy in 2015.■

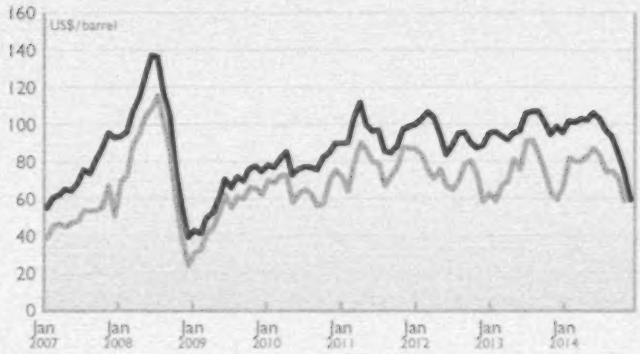
OIL PRICE

Back

Oil prices keep falling

The price of oil continued to plummet in December; the monthly average for West Texas Intermediate reached its lowest point since April 2009 (graph). Since June, the price has plunged by slightly more than 40%. At the beginning of January 2015, the price slipped below the US$50 per barrel threshold. It is the overabundance of global supply, combined with the anticipated weakness of demand, that has pushed prices down in the market. Keep in mind that during the last recession, the price of oil fell below US$40 per barrel.■

Price of crude oil
(January 2007 to December 2014)



Source: Global Insight et Alberta Office of Statistics and Information

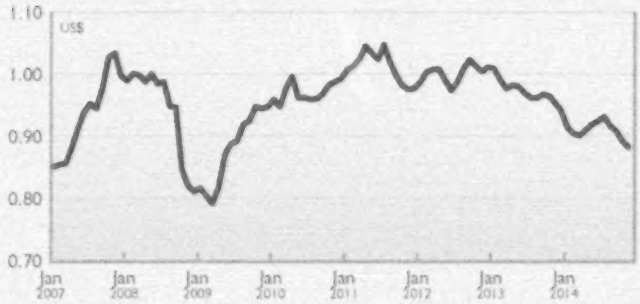
CANADIAN DOLLAR

Back

The Canadian dollar depreciates further

The Canadian dollar depreciated for the fifth month in a row, losing 1.8% of its value against the U.S. dollar in December. The depreciation that has been observed since June is largely attributable to the plunge in the price of crude oil, of which Canada is a net exporter. In the past few days, the loonie has slipped below US$0.84.■

Canada/United States exchange rate
(monthly data, January 2007 to December 2014)



Source: Bank of Canada

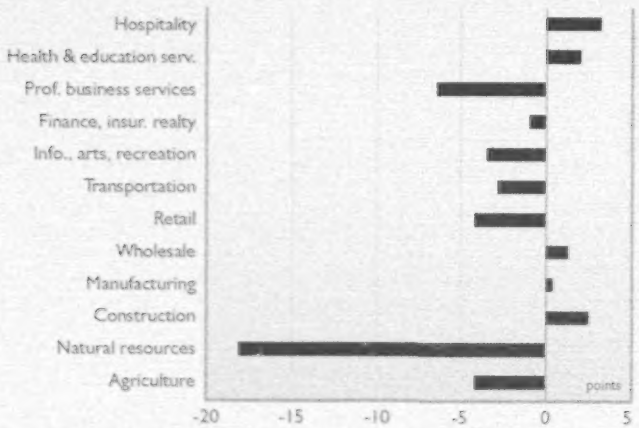
SME CONFIDENCE

Back

SME owners' confidence erodes

The Business Barometer Index has lost 3.9 points in December 2014, landing at 61.9, its lowest level since June 2013. This downturn is largely linked to the tumbling oil prices, since the confidence of SME owners declined mainly in Newfoundland and Labrador, Saskatchewan and Alberta, all provinces whose economies are very dependent on oil production. Compared with where it stood in June, before the oil price slump, the natural resources sector index has lost 18 points (graph). Confidence has waned in many other sectors as well. It could be that business leaders' confidence is being undermined by other factors, but some of them may be apprehending repercussions from an economic slowdown caused by lower oil prices. On the other hand, confidence has not declined in the manufacturing sector, and it has risen in that of hospitality, two sectors that are likely to benefit from the depreciation of the exchange rate resulting from lower oil prices.

Business Barometer
(Change from June 2014 to December 2014)



Source: Canadian Federation of Independent Business

KEY INDICATORS—CANADA

Back

Key indicators—Canada

	Historical[1]				2014[2]						Forecast	
	2010	2011	2012	2013	Q1	Q2	Q3	Q4	Latest[3]		2014	2015
Real GDP (% growth)	3.0	1.9	2.0		1.0	3.6	2.8		oct	0.3	2.4	2.5
Machinery and Equipment Expenditures (% growth)	8.1	1.9	-1.7		-5.0	1.4	5.2				-0.9	4.0
Pre-Tax Corporate Profits (% growth)	23.3	-6.7	0.7		26.6	6.7	3.9				9.6	2.3
Industrial Production (% growth)	4.1	1.4	1.8		4.7	4.1	1.3		oct	0.6	3.5	2.3
Industrial Product Prices (% growth)	6.9	1.1	0.4		12.7	0.5	-1.2		nov	-0.4	2.3	0.8
Non-Residential Construction (% growth)	15.9	13.5	5.0		-0.3	0.5	-1.9					
Housing Starts ('000 units)	194	215	188	189	175	197	199	185	dec	181		183
Personal Expenditures (% growth)	2.2	1.9	2.5		1.5	4.4	2.8				2.7	2.3
Consumer Price (% growth)	2.9	1.5	1.0		2.8	3.7	0.3		nov	-0.4	2.0	1.7
Employment (% growth)	1.5	1.2	1.3	0.8	0.4	0.3	1.4	1.8	dec	0.0		
Unemployment Rate (%)	7.4	7.3	7.1	6.9	7.0	7.0	6.9	6.6	dec	6.6		6.6
SMEs Confidence Index (CFIB)	66.4	63.9	63.9	64.9	64.2	65.4	64.7	65.1	dec	61.9		
Manufacturers Confidence Index (CFIB)	67.3	66.7	63.8	65.8	64.9	64.6	69.0	64.9	dec	64.1		

1. Annual growth rate
2. Quarterly growth, at annual rate
3. Month-over-month growth

Sources: Statistics Canada, Consensus Economics and Canadian Federation of Independent Business.

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